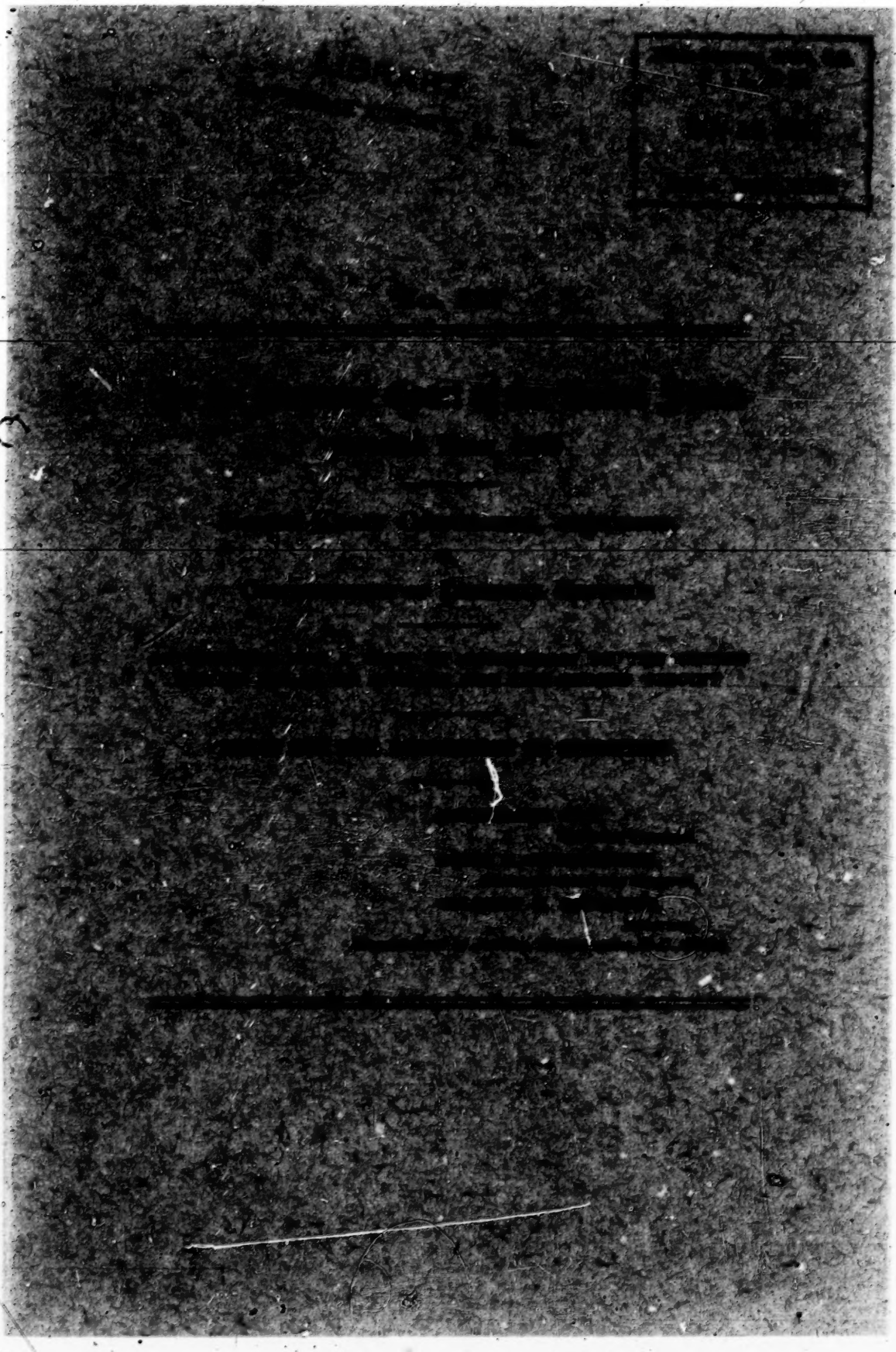


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In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 537

NORDEN-KETAY CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (Pet. 11a–23a) is not officially reported. The opinion of the court of appeals (Pet. 1a–8a) is reported at 319 F.2d 902.

JURISDICTION

The judgment of the court of appeals was entered on June 28, 1963 (Pet. 9a). A timely petition for rehearing was denied on July 30, 1963 (Pet. 10a). The petition for a writ of certiorari was filed on October 10, 1963. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below correctly disallowed the taxpayer's 1954 deduction of a net operating loss carried over from 1951 on the ground that there was not the necessary "continuity of business enterprise" between the enterprise suffering the loss and the enterprise seeking the benefit of the deduction.

STATUTES INVOLVED

Section 172(a) and (g) of the Internal Revenue Code of 1954 and §§ 23(s) and 122 of the Internal Revenue Code of 1939 are set out in part in the Appendix, pp. 16–17, *infra*.

STATEMENT

Prior to 1951, petitioner was engaged in the business of mining and selling bituminous coal under the name of Consolidated Coal Corporation. During the fall of 1950, an agent representing petitioner's largest shareholder interested the New York banking firm of Lehman Brothers in buying the stock of petitioner. Lehman Brothers acquired options to purchase a controlling share of the stock and then undertook to find a purchaser for the stock at a price that would yield it a $200,000 profit. It ultimately entered into an agreement for the sale of the enterprise to the Zeigler Coal & Coke Company at approximately the desired price, but at Zeigler's request the agreement was for the sale of petitioner's assets rather than its stock. Having found a purchaser, Lehman Brothers exercised its options and became the owner of 95% of petitioner's stock (47,447 shares). Two days later,

on February 28, 1951, petitioner transferred to Zeigler all its assets except cash and securities in exchange for an assumption of all of petitioner's liabilities and the payment of an amount of cash which, together with the retained cash and securities, gave petitioner liquid assets in the amount of $3,900,000. In addition, Zeigler promised to give petitioner a share of the proceeds from certain of the properties for which it had no need and which it proposed to resell (the "disposable properties") (Pet. 13a–15a). In order to cut off any contingent claims against the corporation (liability for which Zeigler had assumed), petitioner was required by the agreement to dissolve itself promptly after receipt of the final payment (see Pet. 9).

Upon consummation of the sale, petitioner filed a notice of intention to dissolve and immediately distributed, as a partial liquidating dividend, the $3,900,000 generated from the sale of the assets.[1] Its share of the distribution was used by Lehman Brothers to satisfy the bank loans and commissions incurred in purchasing the stock. About a year later, on March 26, 1952, petitioner accepted $250,000 in full satisfaction of its rights to share in the proceeds of Zeigler's sale of the "disposable properties" and promised, in accordance with the original agreement, to complete dissolution as quickly as possible (Pet. 15a, 17a).

[1] $3,824,541 was distributed immediately and the balance a little over two months later, in May 1951 (Pet. 15a; see Pet. 10).

At about the time of the final payment (March 1952), Lehman Brothers learned for the first time that the basis for petitioner's assets had been much in excess of the sale price and that their sale had accordingly given rise to a net operating loss for petitioner's 1951 taxable year in the amount of $3,466,387. Of that amount, $207,839 was absorbed by carryback to prior taxable years, but Lehman Brothers was advised that the remaining $3,258,548 of the loss might be eligible for carryforward to future years (Pet. 11–12, 18, 16a). In order to realize the benefit from its newly-discovered tax asset, petitioner undertook negotiations, ultimately successful, to be released by Zeigler from its commitment to dissolve,[2] abandoned its dissolution proceedings, and began searching for a profitable going concern to acquire (Pet. 15, 18a).

On April 6, 1953, petitioner entered into an agreement with the stockholders of a group of three closely-held companies engaged in the manufacture and sale of precision electronic components (the "Ketay" companies). Pursuant to the agreement, petitioner acquired all the stock of the Ketay companies, dissolved them, received their assets, elected the former Ketay stockholders as directors and officers, and, with an appropriate change of name (to Ketay Manufacturing Company) commenced operations as an electronic components manufacturer. In exchange for the Ketay stock, petitioner gave the

[2] To obtain the release, petitioner was required to reassume liability for any claims that would have been cut off by a timely dissolution (Pet. 15).

Ketay stockholders: $100,000 in cash; notes for $2,650,000 payable in installments over a five-year period; and warrants to purchase 25,000 newly-authorized shares of its common stock for $125,000.[3] The warrants were exercised in due course and gave the old Ketay stockholders approximately 34% of the outstanding stock of petitioner (Pet. 18a–21a).

Petitioner's net income from the electronics business was $1,108,410 for 1953 and $1,226,880 for 1954 (Stip. ¶ 44). For both years it claimed net operating loss carryovers from 1951 which completely eliminated its taxable income. For 1954, the year involved in this proceeding, the Commissioner disallowed the carryover deduction and determined a deficiency, as a consequence, in the amount of $630,033. The Tax Court upheld the deficiency (Pet. 11a–23a), and the court of appeals affirmed (Pet. 1a–8a).

ARGUMENT

Prior to February 1951, petitioner was engaged in the mining and sale of bituminous coal. In that month, Lehman Brothers acquired 95% of its stock in

[3] The exercise price of $5.00 per share, as petitioner notes (Pet. 16, n. 5), was "approximately equal to the underlying net assets value of petitioner's shares at the time," *i.e.*, the $250,000 in cash received from Zeigler divided by 50,000 authorized shares." It did not, however, reflect either the value of petitioner's major existing asset—a net operating loss of $3,258,548 which, if allowed as a carryforward, would produce (at a 52% tax rate) a tax saving of $1,694,445—or the value of the newly-acquired assets. Thus, contrary to petitioner's implication, the warrants to purchase the stock were exercisable at a relatively nominal price and were an important part of the consideration given by petitioner for the assets acquired.

order to effectuate a pre-arranged sale of all of its assets. Upon consummation of the sale, all of the proceeds except for the final payment of $250,000 were distributed in liquidation and dissolution of the corporation was initiated. For the following two years, petitioner was a defunct corporation. It had no operating assets, no business, and no prospects. It did, however, have a net operating loss of over $3 million which, if it could be carried over against the income of some other business, would yield a tax saving of over $1.5 million. In April 1953, the petitioner's corporate shell was utilized to absorb an existing electronics business previously operated by three corporations wholly unrelated to petitioner. After petitioner's absorption of the Ketay enterprises, Lehman Brothers owned 58.5% of the common stock[1] and the Ketay stockholders owned 34%, plus corporate notes in the amount of $2,650,000. The $250,000 cash that petitioner brought to the amalgamation was minor in relation to the total value of the enterprise, and the major consideration for the substantial

[1] In March 1951, following Lehman Brothers' recovery of all but $1.50 per share of its original investment, it sold 7116 of its 47,447 shares for $1.50 a share to persons (Becker and Weir) who were entitled to participate with it in any profit from the venture (Pet. 16a). Since those persons had participating rights in the venture from the outset, however, we will treat them as co-participants of Lehman Brothers and ignore that transfer of ownership. In April 1951, Lehman Brothers sold 3500 shares to a third party (McConnell), reducing its holding to 43,947 shares (Pet. 16a). That reduced holding was about 88% of the shares originally outstanding (50,000) and about 58.5% of the shares outstanding (75,000) after the issuance of 25,000 new shares to the Ketay stockholders.

interests Lehman Brothers acquired in the electronics enterprise was the $3 million net operating loss available to petitioner. Conversely, what the Ketay stockholders got in exchange for the substantial interests in the electronics business they gave up in the amalgamation was primarily the prospect that, by virtue of petitioner's loss carryovers, the next $3 million of income produced by the business would be tax-free. In substance, the transaction was but a "merger," in a non-technical sense, of petitioner's net operating loss with the Ketay enterprises' profitable electronics business, to the benefit, hopefully, of the former stockholders of both. The courts below held that the Code did not contemplate such a use of a net operating loss carryover, and accordingly disallowed the claimed deduction of the losses of the former coal business against the post-amalgamation income of the electronics business. That decision, we submit, is correct and there is no conflict of decisions or other reason for review by this Court.

1. Although involving a different factual situation, this case is controlled by the rationale of this Court's decision in *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382. The loss carry-over provisions of the Internal Revenue Code of 1939 were there interpreted to require a "continuity of business enterprise" between the corporation sustaining the losses and the corporation seeking to offset those losses against income in later years. The Court recognized that "Congress primarily was concerned with the fluctuating income

of a single business" (353 U.S. at 387), and that the carry-over provision was "designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year" (353 U.S. at 386). Consequently, the Court held that a corporation formed by the merger of 17 commonly-owned corporate entities could not, because of want of "continuity," deduct losses carried over from three of the merged corporations.

The result reached by the court of appeals in the present case follows *a fortiori* from the holding of *Libson Shops*. In *Libson Shops*, the only lack of continuity (since the same stockholders owned the corporations both before and after the merger and the several businesses, although Consolidated, remained unchanged) was that the pre-merger losses of three of the stores were being used to offset the post-merger income of the *other* stores. Here, however, petitioner seeks to carry over losses sustained while engaged in one business enterprise under the ownership of one set of stockholders against income realized in an entirely different business venture under significantly different ownership. Apart from the fact that the two businesses were conducted under the same corporate charter—a formalistic test eschewed by this Court in *Libson Shops*—the only connection between the two enterprises is that Lehman Brothers, having acquired an interest in one solely to consummate a pre-arranged sale of its assets, then traded the tax advantages promised by the resulting losses for a participating interest in the profits of the other. That relationship is plainly inadequate to bring this

case within the reach of the congressional concern on which the carryover provisions are based. As the court of appeals said (Pet. 5a–6a):

> No intelligible legislative purpose would be served by permitting a substantially new group of shareholders engaged in a different enterprise to benefit from the losses sustained by earlier owners in another business. In such a case, the corporate entity is the only link between them. The basic teaching of *Libson Shops* is that this is not enough. * * *

2. Petitioner contends (Pet. 23–30) that this Court's decision in *Libson Shops* stands only for the narrow proposition that a merger between corporations *A* and *B* does not entitle the merged corporation to offset *A*'s earnings with *B*'s pre-merger operating loss if *B* was not so affiliated with *A* before the merger that the two could then file a consolidated return and thereby net their profits and losses. This restrictive reading of *Libson Shops* is contrary to the understanding of that opinion applied in a consistent line of decisions in courts of appeals. See *J. G. Dudley Co.* v. *Commissioner*, 298 F. 2d 750 (C.A. 4); *Commissioner* v. *Virginia Metal Products, Inc.*, 290 F. 2d 675 (C.A. 3), certiorari denied, 368 U.S. 889; *Mill Ridge Coal Co.* v. *Patterson*, 264 F. 2d 713 (C.A. 5), certiorari denied, 361 U.S. 816; *cf. Willingham* v. *United States*, 289 F. 2d 283 (C.A. 5), certiorari denied, 368 U.S. 828; *Patten Fine Papers* v. *Commissioner*, 249 F. 2d 776 (C.A. 7).

Moreover, petitioner's proposed reading is not supported by this Court's stated rationale in the *Libson Shops* opinion, which placed emphasis not on what

the merged corporations could or could not do prior to the merger[8] but on the continuity of the business venture. The Court limited the availability of the carry-over provision to cases in which "there is a continuity of business enterprise," a standard which was further explained as limited to the situation in which "income is derived from the *operation* of substantially the same *business* which produced the loss." 353 U.S. at 386. (Emphasis added.)

Finally, as the court of appeals suggested (Pet. 7a), the carryover in this case would not be allowable even if *Libson Shops* were limited, as petitioner would limit it, to cases involving a "merger" of previously unrelated corporations and an attempt thereby to "pool" profits and losses that "had arisen in separate pools" (Pet. 26–27). For the fact is that this case does involve, in every but the most technical sense, just such a "merger" of previously-unrelated corporations. At the corporation level, the transaction resulted, just as would a merger, in the putting together in one corporate entity of the assets of several formerly-separate corporations: the Ketay corporations contributed the operating assets of their going electronics business, and Consolidated contributed its remaining $250,000 of undistributed cash and a potential loss carryover of $3 million. At the

[8] Indeed, it was assumed in *Libson Shops* that the merging corporations *could* previously have filed consolidated returns and had merely "chosen" not to (see 353 U.S. at 388). While the assumption was erroneous, petitioner's explanation would thus make the decision inapplicable to the very circumstances assumed by the Court in deciding the case.

stockholder level, the transaction resulted, again just as would a merger, in the stockholders of the several "merging" corporations all becoming stockholders of the single surviving corporation, thus keeping their investment in the enterprise "in solution": the Consolidated stockholders remained as stockholders of the surviving corporation, and the Ketay stockholders received 34% of the stock of the surviving corporation as a major part of the consideration for the contribution of the Ketay properties (see note 3 *supra*). The Ketay stockholders also, it is true, received notes, but the notes were dependent for their payment upon the continued financial success of the contributed electronics business and thus similarly represented a continuing interest in that enterprise.[6] Thus, far from being a mere "purchase" of assets by a single corporate entity, this case involves, just as did *Libson Shops*, a "pooling" of the assets of several previously unrelated corporations with their stockholders retaining their investment in the enterprises as stockholders of the "pooled" enterprise. In petitioner's own words, if a "post-merger deduction of pre-merger losses" were allowed in such circumstances, "the stockholders would thereby retroactively have achieved a netting of profits and losses which was not allowable under the organizational form originally

[6] The extent of the Ketay stockholders' continuing "participation" in the surviving corporation is reflected also in their becoming its officers and continuing to manage the business.

selected. A merger alone should not retroactively create such a tax advantage" (Pet. 28–29).[7]

3. The decision below is not in conflict with *Hawaiian Trust Co.* v. *United States*, 291 F. 2d 761 (C.A. 9). In that case, the "Refiners" corporation, in 1950, acquired sufficient stock (over 95%) of the "Hilo Gas" corporation to qualify it as an "affiliate" for purposes of filing consolidated returns. After the stock acquisition, Hilo Gas sold its operating assets, partly to Refiners but mostly to another corporation (Honolulu Gas) also owned by Refiners' stockholders. Hilo Gas continued in existence, but its activities thereafter were confined primarily to subletting office space, in buildings it leased, to Refiners and Honolulu Gas. The sale of its assets, which produced a substantial loss, was reported on a consolidated return for

[7] The only distinction of this case that petitioner's argument would permit is that the "merger" in *Libson Shops* was a tax-free "reorganization" so that no gain or loss was recognized on the exchanges incident to it. In this case, petitioner's acquisition of the Ketay stock (or assets) did not qualify as a "reorganization" because it was not "solely * * * for * * * voting stock" but for stock warrants and notes (§ 112(g)(1)(B) and (C), 1939 Code), and the Ketay stockholders were accordingly taxable on the gain, if any, realized by them in exchanging their Ketay stock for petitioner's stock warrants and notes. Petitioner has yet to explain, however, why there is *more* reason to allow a loss carryover across a taxable merger than across a nontaxable one. Any such distinction would mean that, in the *Libson Shops* context, a loss carryover could be assured by the simple expedient of arranging the merger so as not to qualify as a "reorganization" (and, if necessary under petitioner's analysis, choosing the "loss" corporation to be the surviving legal entity).

1950 filed by Refiners and Hilo Gas. The loss was later sought to be carried over to a consolidated return for the same group filed for 1953. Rejecting on the facts a claim that the Hilo Gas stock had been acquired for the purpose of "evasion or avoidance" of income tax so as to bar the deduction under § 129 of the 1939 Code, the court allowed the loss carryover.

Although the differences between the cases are many, the most obvious is that in *Hawaiian Trust* the enterprise whose profits were sought to be reduced by the carryover (by means of a consolidated return) was already affiliated with the enterprise incurring the loss at the time the loss was incurred. The real question there was whether Refiners was entitled to file a consolidated return with Hilo Gas in 1950, the year the loss arose, for, if it was, there could be no greater objection to the loss being carried forward to subsequent consolidated returns for the same corporate group. This case would be analogous to *Hawaiian Trust* (though differences would still remain) only if petitioner's stock had initially been acquired, not by Lehman Brothers but by the Ketay corporations themselves,[*] and petitioner and the Ketay corporations had then filed a consolidated return for 1951 reporting the post-affiliation loss. Because of the factual differences, moreover, the only issues discussed by the court in *Hawaiian Trust* concerned the application of § 129 of the 1939 Code (tax-avoidance

[*] To establish the necessary relationship for consolidation, the three Ketay corporations might have had first to merge themselves into a single corporation which, upon acquiring petitioner's stock, would become its parent.

acquisitions) and eligibility to file consolidated returns under § 141; *Libson Shops* was not even cited.

4. The *Libson Shops* case involved a taxable year fully governed by §§ 23(s) and 122 of the 1939 Code. Although this case involves transactions (including petitioner's acquisition of the Ketay properties) occurring during 1939 Code years, the carryover being claimed is to a year (1954) governed initially by § 172 of the 1954 Code.* Despite their somewhat different form, however, petitioner does not claim that there is any important difference between § 172 itself—the basic carryover provision of the 1954 Code—and the predecessor provisions of the 1939 Code that were construed by this Court in *Libson Shops*.

In addition to the basic carryover provision (§ 172), the 1954 Code contains two new provisions expressly prescribing the extent to which net operating losses may be carried over across tax-free "reorganizations" (§ 381) and expressly denying a corporation the right to carry over losses following certain changes of ownership (essentially, a 50% change) and a simultaneous change of business (§ 382). Those provisions,

*Section 172(g)(4) provides in turn, however, that "the determination of the taxable years * * * to which a net operating loss for any taxable year ending before January 1, 1954, may be carried shall be made under the Internal Revenue Code of 1939." Whether the 1939 Code is controlling for any purpose other than determining the number of years over which a loss may be carried forward is immaterial here, since, as noted in the text, there is no difference material to the question here between § 122 of the 1939 Code and § 172 of the 1954 Code.

however, are applicable only in the case of transactions occurring after June 22, 1954, the date of the 1954 Code (see § 394 (a) and (b)), and thus have no application to this case. Petitioner's arguments based upon those provisions (Pet. 31–39) are accordingly irrelevant. Far from being a reason for review of this case, a consideration of the effect of those provisions must await a case involving transactions occurring after their effective date.

CONCLUSION

For the foregoing reasons, the petition for certiorari should be denied.

Respectfully submitted.

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NOVEMBER 1963.

APPENDIX

Internal Revenue Code of 1939 (as amended, 26 U.S.C., 1952 ed.):

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(s) *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

* * * * * * *

SEC. 122. NET OPERATING LOSS DEDUCTION.

(a) *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) *Amount of Carry-Back and Carry-Over.*—

* * * * * * *

(2) *Net operating loss carry-over.*—

* * * * * * *

(B) *Loss for taxable year beginning after 1949.*—If for any taxable year beginning after December 31, 1949, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the five succeeding taxable years. * * *

* * * * * * *

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

> SEC. 172. NET OPERATING LOSS DEDUCTION.
>
> (a) *Deduction Allowed.*—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.
>
> * * * * * *
>
> (g) *Special Transitional Rules—*
>
> (1) *Losses for taxable years ending before January 1, 1954.*—For purposes of this section, the determination of the taxable years ending after December 31, 1953, to which a net operating loss for any taxable year ending before January 1, 1954, may be carried shall be made under the Internal Revenue Code of 1939.
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> * * * * * *

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